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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Amendments to Uniform System of Accounts for Interconnection	)	CC Docket No. 97-212
	)	
	)	

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association ("USTA") hereby submits comments in the above-captioned proceeding[1] as the principal trade association of the incumbent local exchange carrier ("ILEC") industry. USTA members will be directly affected by the Commission's actions in this docket.

I. INTRODUCTION

This proceeding proposes new rules for accounting treatment of transactions related to interconnection, unbundled network elements ("UNEs"), and resale in the Federal Communications Commission's Part 32, Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies. In proposing new Part 32 rules, the Commission purportedly seeks "uniformity in reporting to facilitate comparisons among

[1] *In the Matter of Amendments to Uniform System of Accounts for Interconnection*, Notice of Proposed Rulemaking ("NPRM"), CC Docket No. 97-212, FCC 97-355, released October 7, 1997. USTA incorporates by reference its Comments filed December 10, 1997 in the Commission's proceeding *In the Matter of Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Notice Of Proposed Rulemaking*, CC Docket No. 80-286, FCC 97-354, released October 7, 1997.

ILECs and to calculate and track investments and performance related to these services."[2]

The Telecommunications Act of 1996[3] was enacted to establish "a pro-competitive, deregulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."[4] Adoption of the Commission's proposal for new Part 32 accounts to record expenses and revenues associated with interconnection, unbundled network elements and resale is not needed given that existing accounts can be used to record expenses and revenues.[5] In addition Part 32 accounts are used for a single purpose, namely to record telecommunications revenues and expenses, and should not be misused for any other purpose. Most importantly, Commission forbearance from enactment of unnecessary regulations is consistent with Congressional intent in favor of deregulation.

II. PROPOSED ACCOUNTING TREATMENT

In the Commission's *NPRM* new Part 32 accounts and additional subsidiary record keeping requirements for reporting revenues and costs associated with interconnection are proposed. The Commission tentatively concludes that new accounts are not necessary for recording revenues and costs associated with infrastructure sharing, number portability, dialing

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2 *NPRM* at 5, ¶5

3 *Telecommunications Act of 1996*, Pub. L. No. 104-104, 110 Stat. 56, *codified* at 47 U.S.C. §§151 et seq.

4 *Telecommunications Act of 1996*, Joint Explanatory Statement of the Conference Committee, Senate Report 104-230 at 113.

5 *See* Attachment 1, Letter from USTA's Porter Childers to the Commission's Ken Ackerman (December 19, 1996).

parity, numbering administration, collocation, pole attachments, and Telecommunications Relay Services.

More specifically, the Commission proposes to include (1) a new Part 32 revenue account, Account 5071, Interconnection and Access to Unbundled Network Elements, in which to record all revenues received by an ILEC from competitive local exchange carriers ("CLECs"), interexchange carriers ("IXCs"), and any other carriers for providing interconnection and UNEs pursuant to Section 251(c)(2) and 251(c)(3); (2) a new Part 32 expense account, Account 6551, Interconnection and Access to Unbundled Network Elements, in which to record the costs of purchasing interconnection and access to UNEs from other telecommunications carriers pursuant to Section 251; (3) new subsidiary recordkeeping categories that will enable carriers (i.e. ILECs) to identify the revenue from and amount paid for interconnection and each UNE (i.e. access to local loops, network interface devices, local and tandem switching capability, interoffice transmission facilities, signaling and call-related databases, operations support system functions, and operator services and directory assistance facilities); (4) a new Part 32 revenue account, Account 5072, Transport and Terminating Revenue, in which to record all revenues received by ILECs for providing transport and termination of traffic subject to Section 251(b)(5); (5) a new Part 32 expense account, Account 6552 Transport and Termination Expense, in which to record amounts paid for transport and termination of traffic subject to Section 251(b)(5); (6) the establishment of subsidiary record categories for the reporting of amounts contained in existing Part 32 revenue accounts that result from the wholesale of telecommunications services pursuant to Section 251(c)(4); (7) a new expense account, Account, 6553, Purchased Telecommunications Service Expense, in which to record all amounts paid by carriers to purchase telecommunications service for resale; and (8) the establishment of subsidiary accounting records in which to record the costs associated with providing interconnection.[6]

III. USTA'S PROPOSED ACCOUNTING TREATMENT

In proposing new Part 32 accounts for interconnection, UNEs and resale, the Commission argues that such accounts are necessary because "no specific accounts have been designated to record the amounts associated with interconnection arrangements."[7] Conversely, the Commission acknowledges that existing Part 32 accounts could be used to record interconnection revenues, but the Commission fears that carriers may use different accounts to record such revenues.[8] To ensure the uniformity that the Commission seeks, it can simply designate which existing accounts are appropriate for the recording of interconnection, UNEs and resale costs and revenues. This simple solution would avoid the need for unnecessary new Part 32 accounts, preclude additional administrative and financial costs for ILECs in maintaining new Part 32 accounts, and would be consistent with the Commission's position in rejecting new Part 32 accounts for infrastructure sharing in favor of "minimal regulatory oversight."[9]

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[6] *NPRM* at 5-9, ¶¶6-14.

[7] *Id.* at 5, ¶5.

[8] *Id.* at 5, ¶5 and note 16.

[9] *Id.* at 9-10, ¶¶15-16. The Commission concluded that there was no need to establish new Part 32 accounts for infrastructure sharing. Similarly, the Commission correctly finds there is no need for new Part 32 accounts for number portability, dialing parity, numbering administration, collocation, pole attachments and Telecommunications Relay Services. The Commission's well-reasoned position is that "new accounts and or subsidiary recordkeeping requirements are not necessary to record the revenues, investments, and expenses associated with these activities because the associated costs and revenues may readily be recorded in existing accounts." *NPRM* at 10, ¶17. USTA agrees and urges uniform application of this policy.

USTA's Comments in this proceeding are consistent with its December 19, 1996 letter to the Commission's Ken Ackerman. In the December 19 letter, which is Attachment 1, USTA stated that existing Part 32 accounts could be used to record revenues for interconnection, UNEs and resale services.[10] In addition, USTA urged the Commission to allow ILECs to use "tracking mechanisms that best fit their individual systems"[11] in accordance with generally accepted accounting standards.

Attachment 2 is an affidavit from J. Gregory Sidak that explains why existing Part 32 accounts, and the use of subsidiary record categories within existing accounts, can provide the Commission with the same information it would receive from new accounts and would also achieve the Commission's stated objectives for uniformity in accounting for interconnection and unbundled network elements, transportation and termination, and resale. The *Sidak Affidavit*, however, makes clear that the Commission's new Part 32 proposals weigh heavily in favor of a regulatory regime that impermissibly seeks to regulate the prices for interconnection, unbundling, and resale by equating ILEC revenues from deploying such services with the regulated cost of these services.[12] The *Sidak Affidavit* correctly explains that the recent decisions of the Eighth Circuit Court of Appeals forbids Commission regulation of prices applicable to interconnection, unbundling and resale.[13]

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[10] *See* Attachment A, Letter from USTA's Porter Childers to the Commission's Ken Ackerman at 1 (December 19, 1996).

[11] *Id.* at 1.

[12] *Sidak Affidavit* at 57, ¶104.

[13] *Id.* at 59-60, ¶110.

The Commission ordered that TELRIC pricing be *imposed* on ILECs for interconnection, sale of UNEs and resale.[14] The Eighth Circuit Court, however, ruled that the Commission has no authority to *mandate* TELRIC or any other pricing methodology for interconnection, UNEs, or resale.[15] Efforts by the Commission to ignore the Court's decisive rulings on this issue through the reestablishment of TELRIC pricing through Commission review of RBOC Section 271[16] applications for authority to provide competitive in-region long distance services have also been challenged. In the consolidated industry *Petition for Immediate Issuance and Enforcement of the Mandate*, pending before the Eighth Circuit Court, USTA and member companies have requested that the Court declare that the Commission's *reassertion* of jurisdiction over pricing of interconnection, UNEs and resale violates the Court's prior rulings against the Commission's policy.[17] Where state commissions have also *imposed* TELRIC pricing, affected companies are appealing such decisions to federal district courts pursuant to Section 252(e)(6) of the 1996 Act.[18] Given this current environment, a revenues equals costs requirement, which the

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[14] *First Report and Order, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, 11 FCC Rcd.15499 (1996).

[15] *Iowa Utilities Board v. FCC*, 120 F. 3d 753 (8th Cir. 1997), *amended on rehearing* October 14, 1997, *petitions for cert. filed* (U.S. November 17, 1997)(Case Nos. 97-826/829/830/831).

[16] 47 U.S.C. §271.

[17] Ameritech, Bell Atlantic, BellSouth, SBC, US WEST and USTA *Petition for Immediate Issuance and Enforcement of the Mandate* (8th Cir. Sept. 18, 1997).

[18] 47 U.S.C. §252(e)(6).

Commission seeks to *impose* on ILECs in this proceeding, is a clear attempt to ignore the issue of embedded costs.

The Commission continues its incremental efforts to resuscitate its jurisdiction authority over pricing issues in this proceeding. The TELRIC pricing methodology, which the Commission seeks to *reimpose* through its revenues equals costs proposal, remains contrary to elementary economic principles that establish that TELRIC pricing does not permit ILECs to fully recover their costs for providing interconnection, UNEs and resale of telecommunications services.[19] Moreover, the Commission's proposed accounts are inconsistent with the current Part 32 rules which specify that the USOA accounts "should not reflect an *a priori* allocation of revenues, investments or expenses to products or services, jurisdictions, or organizational structures."[20]

Contrary to the Commission's view, Part 32 accounts are not necessary to "facilitate comparisons among ILECs and to calculate and track investments and performance related to these services."[21] The Commission recognizes that the purpose of Part 32 accounts is simply to record expenses and revenues of services provided by ILECs. As the Commission stated:

> Part 32 expense and plant accounts are used to record costs associated with ILECs' provision of products and services to customers. Part 32 revenue accounts are used to record ILEC revenue associated with products and services customers

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19 *Sidak Affidavit* at ¶¶105-106.

20 47 C.F.R. §32.2(c).

21 *NPRM* at 5, ¶5

> purchase .... [T]he accounts are intended to reflect a functional and technological view of the telecommunications industry. [22]

The Commission's proposals for new Part 32 accounts bear no relationship to the historical purpose of Part 32 accounting. Clearly, existing Part 32 accounts are more than adequate to record the expenses and revenues derived by ILECs from interconnection, UNEs and resale. USTA urges the Commission to adopt the following proposals for using existing Part 32 accounts for recording expenses and revenues from interconnection, UNEs and resale which result from local competition.

A. Interconnection and Unbundled Network Elements

The revenues for these services should be recorded in Account 5240, Rent Revenue[23], as the furnishing of UNEs consists of the rental of ILEC telecommunications facilities. ILECs are currently maintaining subsidiary records for the recording of the revenues from individual UNEs. The Commission's objective of uniform accounting can be met by requiring subsidiary record categories within Account 5240, the account in which most LECs currently record revenues from these services. The cost for the purchase of UNEs should be recorded in Account 6540, Access Expense. Moreover, the Commission should not require subsidiary tracking of low-cost UNEs.

B. Transportation and Termination

Transportation and termination are interdependent. Most ILEC billing systems use one rate for transportation and termination combined. The Commission should require that only one

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22 *Id.* at 3-4, ¶4.

23 Account 5240 provides for "... space in conduit, pole line space for attachments, and any allowance for return on property used in joint operations and shared facilities agreements."

subsidiary record category for transportation and termination combined be maintained, and that category should be recorded in Account 5240.

The cost associated with the purchase of transport and termination should be recorded in Account 6540, Access Expense, where LECs currently record expenses associated with transport and termination purchased from independent telcos.

C. Resale

Account 6540, Access Expense, should be used for the recording of any expense associated with the purchase of resold services. USTA agrees with the Commission that revenues associated with resale should be recorded in associated end-user revenue accounts.

USTA believes that this accounting proposal will permit uniformity in reporting, facilitate comparisons among ILECs, and provide for the calculation and tracking of investment and performance related to these services. This proposal is also in accordance with the financial-based accounting system adopted by the Commission on May 15, 1986, which reflects recurring functions that take place in the course of providing products and services to customers.

IV. COST OF PROVIDING INTERCONNECTION AND UNEs

USTA agrees with the Commission that the cost of providing interconnection and access to UNEs should continue to be captured in existing Part 32 accounts. However, the Commission should not require that additional special studies be conducted for the purpose of establishing subsidiary records to identify interconnection costs.

Many negotiated agreements are already in place between ILECs and CLECs. The Commission should not require ILECs to now, after the fact, perform Part 32 detail cost studies for these agreements.

Existing cost studies do not contain Part 32 accounting detail. Requiring new cost studies that would require Part 32 account specificity would be unduly burdensome. No special accounting is needed for expenses incurred in the provisioning of interconnection or UNEs. The Commission should address cross-subsidy concerns in the separations reform proceeding.

V. CONCLUSION

New accounts are not needed in order to implement uniformity in accounting for interconnection activities. USTA supports the Commission's tentative conclusions that new Part 32 accounts are superfluous for recording expenses and revenues for infrastructure sharing, number portability, dialing parity, numbering administration, collocation, pole attachments, and Telecommunications Relay Services because existing accounts suffice. By using Account 5240 to record revenues and Account 6540 for tracking expenses associated with purchasing interconnection, the Commission can accomplish its goal of uniformity in recording revenues and expenses without adding service specificity to Part 32 accounts. Furthermore, the Commission's proposal to reflect cost study results in subsidiary accounting records is not only unduly burdensome, but is in direct conflict with the Part 32 rules which guard against service specific allocation of expenses. ILECs must have flexibility to record revenues and expenses in accordance with generally accepted accounting standards.

Respectfully submitted,

UNITED STATES TELEPHONE ASSOCIATION

December 10, 1997

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Its Attorneys

UNITED STATES
TELEPHONE
ASSOCIATION

December 19, 1996

Mr. Kenneth M. Ackerman
Chief, Accounting Systems
Federal Communications Commission
Accounting and Audits Division
2000 L Street, NW, Room 812
Washington, DC 20006

Dear Ken,

At the September 25 NARUC meeting, you asked the industry's opinion regarding the establishment of new accounts for interconnection revenue. The purpose of this letter is to respond to your question.

USTA's members do <u>not</u> believe the FCC should establish new accounts for interconnection revenue. Nevertheless, companies <u>are</u> planning to track interconnection revenues. The data is needed to satisfy internal management requirements. However, companies should be permitted to use whatever tracking mechanisms best fit their individual systems. For example, some companies may use subaccounts to track interconnection revenues while other companies may use billing codes. Regardless of their approach, companies will be able to identify interconnection revenues. As long as interconnection revenues are identifiable, USTA sees no advantage in requiring new Part 32 accounts.

While we do not support new Part 32 accounts, USTA recognizes the need for consistent accounting treatment throughout the industry. Accordingly, we propose accounting for the various elements of interconnection revenue as described below.

<u>Resale Revenue</u>

Resale services should be booked to the same account as the retail revenue for that service. For example, if a company resells local service, the interconnection revenue should be booked to Account 5001, *Basic Area Revenue*. Likewise, if a company resells call forwarding or call waiting, the interconnection revenue should be booked to Account 5060, *Other Local Exchange Revenue*.

Directory Assistance Revenue
Revenue derived from providing directory assistance under the interconnection order should be booked to Account 5060, *Other Local Exchange Revenue*. This is the same account LECs use to record revenue from directory assistance provided to their own customers. Thus, this accounting is consistent with the treatment proposed above for resale customers.

PIC
When customers change carriers, interlata PIC should be booked to Account 5082, *Switched Access Revenue*; intralata PIC should be booked to Account 5084, *State Access Revenue*. Call forwarding revenues for number portability should be booked to Account 5060, *Other Local Exchange Revenue*.

Unbundled Revenue
In the Interconnection Order, the FCC stated that unbundled revenues are non-jurisdictional. However, the Order does not specifically address how the new interconnection requirements interact with existing Commission rules. USTA believes the best way to accomplish the non-jurisdictional dictate is to book unbundled revenues to Account 5240, *Rent Revenue*. This approach conforms with existing FCC regulations.

If you have any questions, please call me at 202-326-7268.

Sincerely,

Porter E. Childers

Porter E. Childers

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

In the Matter of	)	
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Jurisdictional Separations Reform and Referral to the Federal-State Joint Board	))	CC Docket No. 80-286
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	)	

AFFIDAVIT OF J. GREGORY SIDAK

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INTRODUCTION

J. Gregory Sidak, being duly sworn, deposes and says:

1. My name is J. Gregory Sidak. I am the F. K. Weyerhaeuser Fellow in Law and Economics at the American Enterprise Institute for Public Policy Research (AEI), where I direct AEI's Studies in Telecommunications Deregulation. I am also a senior lecturer at the Yale School of Management, where I teach a course on telecommunications regulation with Professor Paul W. MacAvoy. I served as Deputy General Counsel of the Federal Communications Commission from 1987 to 1989, and as Senior Counsel and Economist to the Council of Economic Advisers in the Executive Office of the President from 1986 to 1987.

2. My academic research concerns telecommunications regulation, antitrust policy, and constitutional law issues concerning economic regulation. I am the author or coauthor of five books concerning pricing, costing, competition, and investment in regulated network industries: *Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States* (Cambridge University Press 1997), with Daniel F. Spulber; *Foreign Investment in American Telecommunications* (University of Chicago Press 1997); *Toward Competition in Local Telephony* (MIT Press & AEI Press 1994), with William J. Baumol; *Transmission Pricing and Stranded Costs in the Electric Power Industry* (AEI Press

1995), with William J. Baumol; and *Protecting Competition from the Postal Monopoly* (AEI Press 1996), with Daniel F. Spulber. I am also the author or coauthor of thirty scholarly articles in the *California Law Review, Columbia Law Review, Cornell Law Review, Duke Law Journal, Georgetown Law Journal, Harvard Journal on Law & Public Policy, Industrial and Corporate Change, Journal of Political Economy, New York University Law Review, Northwestern University Law Review, Southern California Law Review, Yale Journal on Regulation*, and elsewhere. Several of those articles, as well as my recent book with Professor Spulber, directly address costing and pricing issues concerning unbundled access to the local telecommunications network.[1]

3. I have testified before the U.S. Senate and House of Representatives, and my writings have been cited by the Supreme Court, by the lower federal courts, and by state and federal regulatory commissions. I have been a consultant on regulatory and antitrust matters to the Antitrust Division of the U.S. Department of Justice, to the Canadian Competition Bureau, and to more than thirty companies in the telecommunications, electric power, natural gas, mail delivery, and computer software industries in North America, Europe, Asia, and Australia.

4. I received A.B. and A.M. degrees in economics and a J.D. from Stanford University, where I was a member of the *Stanford Law Review*. I served as a law clerk to Chief Judge Richard A. Posner during his first term on the U.S. Court of Appeals for the Seventh Circuit.

5. I submit this affidavit in my individual capacity and not on behalf of the American Enterprise Institute or the Yale School of Management.

EXECUTIVE SUMMARY

6. I have been asked by the United States Telephone Association to explain how, particularly during the transition from regulation to competition in local telephony, the jurisdictional separation provisions

1. J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851 (1996); J. Gregory Sidak & Daniel F. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements Under the Telecommunications Act of 1996*, 97 COLUM. L. REV. 1081 (1997); J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings, and the Fallacy of Forward-Looking Cost*, 72 N.Y.U. L. REV. 1068 (1997).

of Part 36 of the Commission's rules and the accounts and additional subsidiary recordkeeping requirements of Part 32 of those rules can interfere with the right of an incumbent local exchange carrier (ILEC), under either the regulatory contract or takings jurisprudence, to recover the common costs that it prudently incurred to provide service to the public. In particular, I respond to the Commission's request for comment on "whether and how to separate the costs associated with interconnection,"[2] and I analyze the difficulties that Part 36 currently creates for the ILEC's ability to recover its common costs associated with the ILEC's mandatory provision under section 251 of interconnection, unbundled network elements, and resale.[3] I conclude that, to ensure that an ILEC will receive a reasonable opportunity to recover its costs of providing interconnection, the Commission should assign all such costs to the state jurisdiction. Furthermore, I respond specifically to the Commission's proposal to create "new Part 32 accounts and subsidiary recordkeeping requirements to record the revenues and expenses related to providing and obtaining interconnection."[4] I conclude that no such new accounts are necessary or in the public interest.

7. Given the complexity of the regulatory process of which jurisdictional separations are a part, it is essential at the outset to identify not only the critical issue raised by the *Separations Notice*, but also the issues that are not directly pertinent. The critical issue here is not cross-subsidization of unregulated services, for that concern is the focus of section 254(k) of the Communications Act[5] and Part 69. Only regulated services are subject to Part 36.[6] Nor is the issue predation in competitive markets, for that concern is the focus of the antitrust laws as well as Part 69. Nor is the issue how to measure incremental costs and common costs, for that is the purpose of Part 32 and other policies of the FCC and the state regulatory commissions. Rather, the critical issue posed by the *Separations Notice* is how to design a system that will maximize

2. Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Notice of Proposed Rulemaking, CC Dkt. No. 80-286, ¶ 4 (released Oct. 7, 1997) [hereinafter *Separations Notice*].

3. 47 U.S.C. § 251.

4. Amendment to Uniform System of Accounts for Interconnection, Notice of Proposed Rulemaking, CC Dkt. No. 97-212, ¶ 2 (released Oct. 7, 1997) [hereinafter *USOA Notice*].

5. 47 U.S.C. § 254(k).

6. The Commission seems to lapse into concerns over cross-subsidization when it notes that it "must determine whether companies regulated under federal price cap regulation should continue to perform jurisdictional separations." *Separations Notice* ¶ 32. Plainly, the Part 69 cost allocation rules are unnecessary for ILECs regulated under price caps that do not include earnings-sharing arrangements. Since the risk of cross-subsidization is nonexistent for such ILECs, it should follow *a fortiori* that there is no reason to deny them the freedom to allocate their common costs across jurisdictional boundaries in any manner that they see fit.

consumer welfare given the constraint (both economic and legal) that the ILEC must be permitted to recover the full amount of its common costs.

8. This affidavit is organized in four parts. Part I argues that compelling economic and legal evidence supports the existence of a regulatory contract that obligates the Commission and the states to ensure that an incumbent LEC has a reasonable opportunity to recover *all* of its costs, both forward-looking and historic. The separations process is part of the regulatory contract. Honoring the regulatory contract serves the public interest because it encourages ILECs to make asset-specific investments to discharge their public service obligations.

9. Part II shows that, like the regulatory contract, the Takings Clause of the U.S. Constitution imposes an analogous constraint on the Commission and the states to ensure that rules that they adopt for allocating costs across the state and federal jurisdictions do not deny the ILEC its reasonable opportunity to recover its full costs of providing service.

10. Part III shows that the costs of interconnection must be recovered in the state jurisdiction. The jurisdictional separation of interconnection costs would invite regulatory opportunism at both the state and federal levels. The Commission cannot make an ILEC's common costs disappear by placing the agency's "forward-looking" gloss on the standard definition of stand-alone cost and thus reducing the amount of common cost that could be assigned to any particular service without supposedly violating the rule for subsidy-free pricing. Nor is it proper for the Commission to ignore in the *Separations Notice* the risk that jurisdictional separation creates in terms of underrecovery of the ILEC's costs. Even in the form that the Commission proposes to revise the separations process, Part 36 does not recognize that allocating the costs of interconnection across both the state and federal jurisdictions would increase the likelihood that the rates for interconnection would fail to recover the full cost of interconnection. The Commission regards the separations process as a safeguard against an ILEC's *over*recovery of its costs, but does not seem not to recognize that *under*recovery of costs is just as serious a threat to consumer welfare. As Parts II and III establish, an ILEC is entitled to recover all of its common costs, not just the portion that the separations process has labelled

"interstate" or "intrastate." The state and federal governments would likely be jointly liable for the incumbent LEC's stranded costs under either contract principles or takings jurisprudence. Indeed, the Commission notes that "the state *and* federal jurisdictions are responsible for ensuring that rates are not confiscatory . . . ."[7] The practical problem, however, is how an ILEC could compel the Commission to accept legal responsibility for its role, through the separations process, in preventing the ILEC's full recovery of its prudently incurred cost of providing service. Stated differently, the problem is the regulator's ability to make credible commitments not to act opportunistically with respect to the nonsalvageable investments made by the ILEC. Once the Commission has allocated some costs of interconnection to the federal jurisdiction, is its promise to the ILEC to permit it a reasonable opportunity to recover those costs a credible commitment in light of the federal government's ability, under various jurisprudential and constitutional doctrines such as sovereign immunity, to shield itself from liability? If not, then the Commission could impose on the relevant state or states the full liability for all of the ILEC's stranded costs arising from the FCC's separations rules concerning interconnection costs. The solution to this problem is to place the responsibility for cost recovery on those regulators who would bear the ultimate legal responsibility for denying an ILEC the reasonable opportunity to recover the total cost of the investments that it prudently made to provide service to the public. The Commission asks whether "statutory, regulatory and market changes" since the Supreme Court's 1930 decision in *Smith v. Illinois Bell Telephone Co.*[8] "have been so pronounced and persuasive as to make its holding inapplicable in our new deregulatory environment."[9] Mandatory open access in local telecommunications is indeed a significant regulatory development since *Smith*, for it significantly complicates the process of cost recovery for the ILEC. That development, however, does not make *Smith* irrelevant but rather militates in favor of assigning all of an ILEC's costs of interconnection to the state rather than dividing those costs between the ILEC's state-regulated and federally regulated services.

11. Part IV argues that the *USOA Notice* provide no persuasive rationale for imposing new Part

7. *Separations Notice* ¶ 35 (emphasis added).
8. 282 U.S. 133 (1930).
9. *Separations Notice* ¶ 3.

32 accounts for the costs of interconnection. To the contrary, the *USOA Notice* telegraphs the Commission's intention, notwithstanding the Eighth Circuit's decision on jurisdiction over interconnection pricing, to use the proposed Part 32 accounts as a means of federally regulating the price of unbundled access to the local telecommunications network.

II. THE REGULATORY CONTRACT OBLIGATES THE COMMISSION AND THE STATES TO GIVE AN ILEC A REASONABLE OPPORTUNITY TO RECOVER ALL OF ITS COSTS

12. The Commission's stated criteria for selecting a separations rule overlook the legal constraints of takings jurisprudence and the regulatory contract. The Commission proposes that its separations rules, and any revisions of those rules, "achieve a reasonable balance" among the three criteria of competitive neutrality, administrative simplicity, and principles of cost causation.[10] That balance is fine as far as it goes. Competitive neutrality is a proper goal of any policy that seeks to effect the transition from regulation to competition.[11] Administrative simplicity is also laudable, provided that the administrative costs being minimized include private compliance costs as well public enforcement costs. The third goal of reflecting cost causation merely restates the usual purpose, from an accountant's perspective, of *any* cost allocation system.[12]

13. What the Commission's "reasonable balance" conspicuously lacks, however, is any recognition that cost recovery is a necessary consequence of both takings jurisprudence and the regulatory contract, for both lines of legal authority seek to protect incentives for investment in the specialized, nonsalvageable capital necessary for the provision of local telecommunications services. Because of that omission, the Commission's criteria for evaluating the separations process are insufficiently attentive to the risk that the Part 36 rules will thwart an ILEC's full recovery of its costs.

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10. *Separations Notice* ¶ 23.

11. *See* J. GREGORY SIDAK & DANIEL F. SPULBER, DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES 497–97, 503–33 (Cambridge University Press 1997) (describing the "equal opportunity" and "impartiality" principles for guiding regulatory policies during the transition to competition).

12. *See, e.g.*, CHARLES T. HORNGREN, GEORGE FOSTER & SRIKANT M. DATAR, COST ACCOUNTING: A MANAGERIAL EMPHASIS 500 (Prentice Hall, 8th ed. 1994).

14. The regulatory contract is an enforceable legal relationship, not a mere metaphor. Substantial historical evidence substantiates the existence of a regulatory contract, and compelling economic arguments confirm the need for such a contract between the local exchange carrier and the state. The separations process modified that contract and inserted the federal government as a party sharing, with the states, contractual obligations to local exchange carriers concerning recovery of their costs of providing service. If the Joint Board fails to put in place separations policies by which the ILEC can fully recover its common costs, those regulators will deny the ILEC its expectation under the regulatory contract—namely, recovery of the cost of providing service to the public. The ILEC's remedy for breach of the regulatory contract would be the standard remedy for breach of any contract: damages for lost expectations.[13]

A. Economic Foundations of the Regulatory Contract

15. Consumers and businesses voluntarily participate in a market transaction only if they receive *gains from trade*—that is, only if the transaction yields positive net benefits for them. A supplier will not invest in a transaction unless he expects the returns from the transaction to cover all costs, including a competitive return to invested capital. That principle is summarized in Armen A. Alchian's classic definition of cost: "In economics, the cost of an event is the highest-valued opportunity *necessarily* forsaken."[14] The supplier's costs of investing in the transaction include the highest net benefit of all opportunities forgone, known as *opportunity cost*.

1. Cost Recovery for Transaction-Specific Investment

16. Cost recovery is an essential element of contract law. Those incurring costs in reliance on a contract must expect to recover those costs, including a return to invested capital. Victor P. Goldberg, for example, has noted of contracts generally:

> Suppose that one party has to make a considerable initial investment and that the value of the investment depends on the continuation of the relationship. An employee

13. Even if one rejects (wrongly) the notion that a legally enforceable contract exists between the incumbent utility and state and federal regulators, related remedies under the common law doctrines of mistake, impossibility, and promissory estoppel would nonetheless entitle the utility to damages sufficient to recover its stranded costs. *See* SIDAK & SPULBER, *supra* note 11, at 210–12.

14. Armen A. Alchian, *Cost*, *in* 3 INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL SCIENCES 404, 404 (David L. Sills ed., MacMillan Co. & Free Press 1968) (emphasis added).

> investing in firm-specific capital is one example; a second would be an electric utility building a plant to serve a particular area. Both will be reluctant to incur the high initial costs without some assurance of subsequent rewards. Other things equal, the firmer that assurance, the more attractive the investment. So, for example, if the utility customers agree to give it the exclusive right to serve them for twenty years, then the utility would find construction of a long-lived plant more attractive than if it did not have such assurance. Of course, if a new, superior technology were likely to appear within three years, the customers would not want the long-lived plant built. Nevertheless, there will be lots of instances in which the parties will find it efficacious to protect one party's reliance on the continuation of the relationship.[15]

Cost recovery is an essential aspect of utility regulation as well.[16] Utilities would not have undertaken the extensive investments required to provide regulated service within their franchise region without the opportunity to recover their costs. In a manner similar to Goldberg's, Daniel Spulber has specifically written about the public utility's recovery of transaction-specific investments under the regulatory contract:

> The regulatory contract is often justified as a means of mitigating the risks of making large irreversible investments that are faced by regulated utilities. Customers of utilities gain from such commitments, since efficient levels of investment yield lower costs of service. There is an incentive to honor commitments regarding compensatory rates of return to assure that regulated firms will undertake future investment and that they will maintain their existing capital equipment. In practice, honoring commitments to investors in regulated utilities keeps down future borrowing costs by reducing investor risk.[17]

The President's Council of Economic Advisers endorsed that economic reasoning in its 1996 report:

> [T]here is an important difference between regulated and unregulated markets. Unregulated firms bear the risk of stranded costs but are entitled to high profits if things go unexpectedly well. In contrast, utilities have been limited to regulated rates, intended to yield no more than a fair return on their investments. If competition were unexpectedly allowed, utilities would be exposed to low returns without having had the chance to reap the full expected returns in good times, *thus denying them the return promised to induce the initial investment.* A strong case therefore can be made for allowing utilities to recover stranded costs where those costs arise from after-the-fact mistakes or changes in regulatory philosophy toward competition, as long as the investments were initially authorized by regulators.[18]

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15. Victor P. Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 AM. BEHAVIORAL SCIENTIST 337, 340 (1980), *reprinted in* READINGS IN CONTRACT LAW 16, 18 (Victor P. Goldberg ed., Cambridge University Press 1989); *see also* Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976).

16. *See* JEAN-JACQUES LAFFONT & JEAN TIROLE, A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION 53–127 (MIT Press 1993).

17. DANIEL F. SPULBER, REGULATION AND MARKETS 610 (MIT Press 1989). For similar analyses in the tradition of Goldberg, see Paul L. Joskow & Richard Schmalensee, *Incentive Regulation for Electric Utilities*, 4 YALE J. ON REG. 1, 8–12 (1986); Dennis L. Weisman, *Default Capacity Tariffs: Smoothing the Transitional Regulatory Asymmetries in the Telecommunications Market*, 5 YALE J. ON REG. 149, 157–61 (1988); Glenn Blackmon & Richard Zeckhauser, *Fragile Commitments and the Regulatory Process*, 9 YALE J. ON REG. 73, 76–78 (1992).

18. 1996 ECONOMIC REPORT OF THE PRESIDENT 187 (Government Printing Office 1996) (emphasis added); *see also* 1997 ECONOMIC REPORT OF THE PRESIDENT 204–05, 207 (Government Printing Office 1997). In 1997 the Antitrust Division of the Department of Justice endorsed the proposition that "stranded costs . . . be assessed on a competitively neutral basis." Hearings before the House Comm. on

The same logic underlies the observation by the Supreme Court of Texas in 1994 that the state's public utility act

> balances the important objective of protecting consumers from monopoly power with the need for financial stability which is required to attract the large amounts of investment capital essential to dependable utility service. When balancing the interests of consumers and utilities, the financial integrity of the utility weighs in favor of both sides. If the utility is forced to pay higher costs of capitalization, the increased costs will eventually be borne by the consumer.[19]

Cost-of-service regulation of public utilities is based on allowing a utility the opportunity to recover its investment, including a competitive rate of return.[20] Utilities have had to undertake substantial investments to discharge their obligation to serve. The purpose of a regulatory contract is to provide for recovery of the full cost of an activity, including direct expenditures, the time cost of money expended for capital investment, and any other opportunity costs. As mentioned earlier, an opportunity cost of an activity is the net benefit forgone from the best alternative activity. The time cost of money is an opportunity cost of an investment because it represents the highest return that the investor could have earned by investing the money elsewhere.

17. The expectation that a utility will be able to recover its costs applies as well to new expenditures that the utility makes to satisfy regulatory obligations, even if the industry is partially or fully deregulated. The utility cannot be asked to provide services in the competitive market at regulated prices that are noncompensatory—that is, at prices that do not allow for full cost recovery, particularly when the firm is mandated to offer unbundled services. Moreover, deregulation of the local exchange does not eliminate the responsibilities of regulatory authorities to allow the ILEC the reasonable opportunity to recover costs *already incurred* to satisfy its obligation to serve. Regulators have a continuing responsibility to allow the ILEC the opportunity to recover those costs.

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the Judiciary, 105th Cong., 1st Sess. (June 4, 1997) (testimony of A. Douglas Melamed, Principal Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice).

19. Texas *v.* Public Utility Comm'n of Tex., 883 S.W.2d 190, 202 (1994) (citations omitted).

20. Jean-Jacques Laffont and Jean Tirole observe, "In the absence of a detailed long-term contract, the regulated firm may refrain from investing in the fear that once the investment is in place, the regulator would pay only for variable cost and would not allow the firm to recoup its sunk cost." LAFFONT & TIROLE, *supra* note 16, at 54.